9-28-1992

Consumption Taxes Belong on the Agenda

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The turmoil in foreign exchange and currency markets during the week of September 14th dramatically demonstrated that no currency is immune to market forces. The lira and the pound collapsed because Italy and Britain were unable to simultaneously sustain domestic prosperity and raise the funds needed to finance their current government spending and meet interest payments on their debts. The crisis was fundamentally due to their long term fiscal failure. The high German interest rates made a peripheral contribution to the crisis.

Fiscal failure, such as Italy and Britain have long endured and which the United States now endures, can be neutralized by a belief that the failure is transitory and will soon be undone by a combination of tax increases and spending constraints. The persistence of fiscal failure will compromise this belief, so that a flight from the currency will overwhelm the exchange markets in spite of massive central bank intervention. The internationalization of finance has eroded the sovereignty of nations.

The compromising of the United States revenue system a decade ago means that the United States is on a course that will in time lead to a sharp run on the dollar. If the next administration is courageous it will face up to the task of constructing a revenue system that yields enough to finance current government expenses which includes ~~,--including~~ interest on the outstanding debt. At that time we ~~The country~~ will have to face the necessity of serious changes in ~~reform-of~~ the structure and level of taxation: new taxes and serious modifications of existing taxes will be on the public policy agenda.

~~The anti tax crusade of the 1980's ignored Oliver Wendell Holmes' dictum "Taxes are what we pay for civilized society".~~ Government spending is now well in excess of 20% of national product and is likely to continue at that level. Our tax system needs to collect a like percent of the national product, not every year but when the economy is at a close approximation to full employment.

Any tax system that raises such a large percent of the national income imposes serious burdens and will affect behavior. It ~~will be~~ is acceptable only if it is deemed just and if it is linked to spending whose effects are visible and pleasant. In a populist world a major part of ~~the~~ tax revenues need to raised by a progressive tax for it to be deemed just.

Income and consumption are alternative bases for a progressive direct tax. A personal income tax is assessed on the market's valuation of the labor and services of assets that a household provides to the production of income. A consumption tax is levied on what a household takes out of the national product for its personal use. The past decade's revolt against taxation indicates that it is not politically feasible for the revenue system to place as large a share of the tax load on income taxes as we did earlier. The mood of the time may be more supportive of taxes based upon consumption than of taxes based upon income.

A progressive consumption based tax biases choices towards the accumulation of financial and other assets and away from consumption. The present tax and spending structure biases decisions towards consumption. It reflects Alvin Hansen's stagnation hypothesis of the 1930's, which held that the outlets for investment deteriorated with the closing of the frontier so that a close approximation to full employment can only be realized if policy fosters high consumption. Our policy discussion is now guided by the view that investment opportunities are virtually unlimited and ~~a~~ prosperity ~~based upon~~ and a higher rate of investment ~~is feasible and~~ is desirable and feasible.

The Individual Retirement Account (IRA) can serve as a model for the mechanism that transforms our present income based direct tax into a consumption based direct tax. Household assets, including real estate, would be considered as part of a portfolio into which an unlimited proportion of each years income could be transferred: this account would be like an open ended IRA. Furthermore the taxpayer would be allowed to withdraw whatever it wishes whenever it wishes to finance consumption. Such withdrawals are not subject to penalties but are subject to the consumption tax.

Our current income tax is a partial consumption tax for deferred compensation and pension fund payments by employers and employees ~~and~~ are not taxed during the period in which these incomes are earned. ~~Withdrawals~~ Payments are taxed when they are paid as per the contract regardless of whether they finance consumption or investment.

A household clearly is consuming the fair rental value of a home or apartment that it owns and occupies. The equitable way to handle owner occupied real estate is to add the fair rental value of the house to the owner occupier's income and consumption and allow the owner occupier to deduct mortgage payments, taxes and spending to maintain or improve the property from the ~~taxable income~~ tax base.

A consumption tax runs into a dilemma with respect to medical care. Arguably medical expenses on pre natal care and child health services are investments and medical expenses of earners during their working career can be considered to be expenses to maintain capital. These expenses reduce the base for the consumption tax. However medical expenses of the aged, whose labor market participation days are past, are consumption expenses. Even though it may be logical to consider such expenses as taxable consumption, taxing the medical expenses of the aged would be outside of society's our usual notion of equity or fairness. The hard logic of the consumption tax has to compromise with the ethos of our time if it is to be politically viable. All, or all but cosmetic, medical care has to be treated as if it were a portfolio change and therefor not subject to the consumption tax.

A consumption tax would not tax any capital gains as long as the proceeds remain within the portfolio. Similarly ~~the problem of~~ shifting one's portfolio from home ownership to financial instruments would not give rise to taxable income.

A consumption tax can make the provision for retirement income a personal decision rather than a benefit or a bounty from an employer. Both corporate and employment volatility has increased markedly over the past decade. This implies that job related pensions, often in the form of a defined benefit, are now inappropriate. In particular defined benefit pension schemes, whether public or private, assume that the organization that is responsible ~~for~~ is financially viable over a long term. The last decade has seen a parade down the bond rating ladder of a host of once blue chips. making the validity of this assumption questionable. It is a rare government or corporation whose financial viability over a thirty year horizon can be taken for granted.

The alternative to defined benefit pensions are defined contribution schemes, where employers and employees contribute to an account which is usually kept in the prospective beneficiary's name and which is portable. Making the contributions to an IRA type account fully deductible and folding the employers contribution to pension schemes into the base wage and salary of the employee liberates the employee from the employer as far as retirement planning is concerned.

Transforming the personal income tax into a consumption tax by revitalizing the IRA's and making them open ended or virtually open ended is no panacea, it is not a sure cure for all the ills of the American economy. Its virtue is that it biases the disposal of income towards accumulating assets, i.e. savings. However an increase in the desire to accumulate does not mean that accumulation increases. That depends upon the strength of investment demand. If transforming the income tax into a consumption based direct tax is to be beneficial it has to be combined with programs that strengthen public and private investment demand.